MEMO# 10375

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PROPOSED AUDIT GUIDE FOR INVESTMENT COMPANIES

[10375] October 14, 1998 TO: ACCOUNTING/TREASURERS COMMITTEE No. 43-98 TAX COMMITTEE No. 31-98 UNIT INVESTMENT TRUST COMMITTEE No. 29-98 RE: PROPOSED AUDIT GUIDE FOR INVESTMENT COMPANIES

____ The AICPA Accounting Standards Executive Committee (AcSEC) recently issued an exposure draft of a revised Audit and Accounting Guide, Audits of Investment Companies (Exposure Draft or Proposed Guide). The Proposed Guide will replace the current Audit and Accounting Guide, which was issued in 1986 and updated only for conforming changes. Among other things, the Proposed Guide provides new guidance on: a) amortization of premium and discount on fixed-income securities, b) organization and offering costs, c) liability recognition in connection with excess expense reimbursement plans, d) capital infusions and corrections of investment restriction violations, e) complex capital structures, and f) financial statement presentation and disclosure of portfolio securities, the components of net assets, and dividend distributions. These proposed changes are described in more detail below. The Proposed Guide also contains specific chapters on taxation of regulated investment companies and unit investment trusts. You may obtain a copy of the Exposure Draft by accessing the AICPA's web site, www.aicpa.org. You may also request one free copy from the AICPA order department by calling 888/777-7077 and requesting product code #800123. Comments on the Proposed Guide must be received by the AICPA by December 22, 1998. Please provide me with any comments on the Exposure Draft by telephone (202/326-5851), fax (202/326-5853) or e-mail (smith@ici.org) by November 13. If you have comments on the tax section of the Proposed Guide, please forward them to Anne Barr (202/326-5837), fax (202/326-5841) or e-mail (barr@ici.org). Amortization of Premium and Discount on Fixed-Income Securities The Proposed Guide requires that premiums and discounts on fixed-income securities be amortized using the interest method. Many funds investing in taxable bonds currently do not amortize premiums for book or tax purposes. Mandatory amortization of premium will affect the characterization of income shown in the statement of operations and in the financial highlights. While this proposed change results in no net increase or decrease in the net gain or loss from investment activities reported in the statement of operations, it will cause a reclassification between net investment income and realized or unrealized appreciation for those fixed-income funds that do not currently amortize premium. In reported in the financial highlights table. Further, the proposed change in accounting policy will cause a "book-tax difference" to the extent the fund does not amortize premium for tax purposes. Transition guidance in the Exposure Draft indicates that the cumulative effect of the proposed change should be reflected as an adjustment to the disclosed amount of the amortized cost of debt securities held as of the beginning of the year in which the Proposed Guide is first applied, based on retroactive recomputation of premium or discount from the initial acquisition date of each security. The cumulative effect of the change should also be reflected as an adjustment of the undistributed net investment income and net unrealized gains or losses as of the beginning of the year in which the Proposed Guide is first applied. Organization and Offering Costs Consistent with SOP 98-5 Reporting on the Costs of Start-up Activities, the Proposed Guide requires that organization costs be expensed as incurred. The Exposure Draft provides guidance on the types of costs that may be considered organization costs and those that may be considered offering costs. Consistent with current practice, open-end funds (and closed-end funds with a continuous offering) should treat offering costs as a deferred charge until operations begin, at which time they would be amortized to expense over twelve months on a straight-line basis. Closed-end fund offering costs should be charged to paid-in capital when shares are sold. The Exposure Draft provides new guidance for unit investment trust offering costs. The Proposed Guide requires that UIT offering costs be charged to paid-in capital on a pro rata basis as the units are issued or sold by the trust (i.e., when the units are purchased by the underwriter). Excess Expense Reimbursement Plans Under an excess expense reimbursement plan, the adviser agrees to reimburse all fund expenses in excess of a stated percentage of average net assets during the first several years of the fund's operations. The investment company agrees to repay the adviser in later years if, and to the extent that, the investment company's net assets increase sufficiently to permit such payments without causing the fund's expense ratio to exceed the stated percentage expense limitation. The economic result of these agreements is to defer payment of the expenses until the investment company is financially able to bear them or, upon termination or expiration of the reimbursement agreement, to eliminate them entirely. Some have argued that a liability is incurred at the time the adviser reimburses the fund and that the fund should recognize that liability. However, the proposed Guide indicates that a liability for such excess expenses should not be recorded by the fund unless all substantive criteria for reimbursement have been met and amounts are actually due under the reimbursement agreement. AcSEC noted that payment of any amount under an excess expense plan depends upon the fund achieving and maintaining a sufficient asset level to support repayment and that there is no assurance that the fund will achieve that asset level. Further, the fixed expiration date of the excess expense agreement could result in the adviser being unable to recover part or all its reimbursement payments to the fund. Capital Infusions and Corrections of Investment Restriction Violations Capital infusions are typically undertaken by an investment adviser to reimburse the effect of a loss attributable to a decline in the value of a portfolio security. Capital infusions may take the form of a direct cash contribution, the purchase of a security from the fund at a price in excess of its current fair value, or provision of a credit enhancement. The Proposed Guide indicates that capital infusions should be reported as contributions to capital, appearing in the statement of changes in net assets immediately after the capital share transactions section, and in the financial highlights table immediately after reported distributions per share. This guidance is consistent with two letters issued by the Chief Accountant in the SEC's Division of Investment Management in 1994 and 1995 addressing money fund bailouts. The Exposure Draft also addresses payments to the fund to compensate it for realized losses on portfolio securities that were purchased in violation of the fund's investment restrictions. The Proposed Guide requires that these payments be reported as a separate line item in the statement of operations immediately after the net realized gain or loss from investments caption. Further, gains recognized by the fund resulting from investment restriction violations during the period should be disclosed in the notes to the financial statements. Complex Capital Structures The proposed Guide includes a separate chapter on accounting, reporting, and auditing of multiple-class funds, master-feeder funds, and funds of funds. This new chapter is primarily derived from SEC rules, letters, and positions in exemptive orders and prevailing industry practice. Disclosure of Portfolio Securities The Exposure Draft proposes to reduce the extent to which investment companies must disclose their portfolio holdings. Under generally accepted accounting principles, registered investment companies would be required to disclose: Each investment (including short sales) constituting more than 1 percent of the fund's net assets, a. All investments in any one issuer aggregating more than 1 percent of the fund's net assets, and b. At a minimum, the fifty largest investments. As you know, SEC regulations currently require registered investment companies to disclose each security holding, regardless of size. Accordingly, unless the SEC were to modify its disclosure requirements, registered investment companies will continue to be required to disclose all portfolio securities, notwithstanding the Proposed Guide. The Institute recently submitted recommendations to the SEC for improving shareholder reports. The Institute 1 See letter to Barry P. Barbash from Craig S. Tyle, August 11, 1998 (Accounting/Treasurers Committee No. 28-98). recommended that the level of detail required in the schedule of investments be reduced, and the ICI's recommendations are generally consistent with the Proposed Guide.1 Disclosure of the Components of Net Assets and Dividend Distributions The Exposure Draft would require investment companies to disclose only two components of capital on the balance sheet: shareholder capital and retained earnings. The components of retained earnings, on a tax basis, would be required to be disclosed in a footnote to the financial statements. This footnote information would enable investors to determine the amount of accumulated and undistributed earnings they potentially could receive in the future and on which they could be taxed. However, SEC regulations require that the components of capital (i.e., shareholder capital, undistributed net investment income, undistributed net realized capital gains, and unrealized appreciation/depreciation) be disclosed on the balance sheet. Accordingly, unless the SEC were to modify its disclosure requirements, registered investment companies will continue to be required to disclose the components of capital, notwithstanding the Proposed Guide. The Exposure Draft proposes that dividends paid be consolidated into a single line item in both the statement of changes in net assets and the financial highlights table. Financial statement footnotes would be required to disclose the tax basis components of dividends paid (i.e., ordinary income and capital gain). Any distribution deemed a tax return of capital would require separate disclosure on both the face of the financial statements and in the footnotes. SEC regulations currently require distributions from net investment income and from realized gains be presented separately, and accordingly, theses regulations would have to be modified in order for consolidated distribution reporting to be implemented. Gregory M. Smith Director - Operations/ Compliance & Fund Accounting